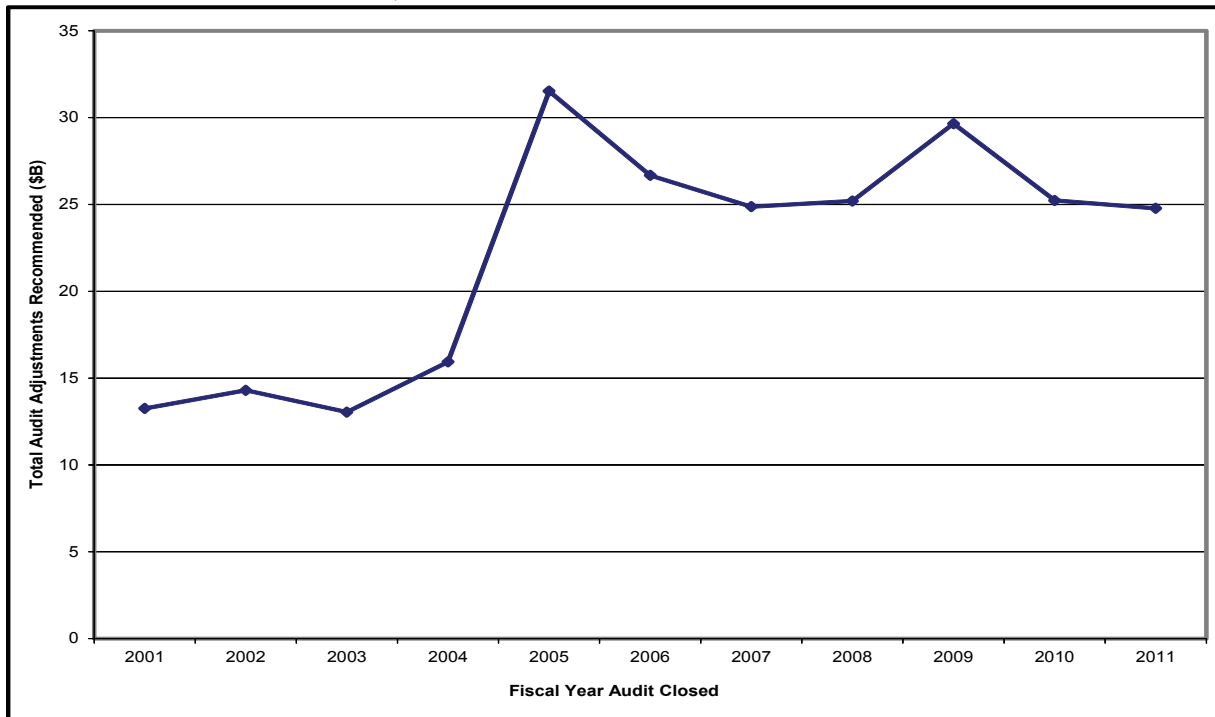


Analysis of Ten-Year Trends in Large Business Examination Results (Fiscal Years 2001–2011)

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The Large and Mid-Size Business (“LMSB”) division, now called the Large Business and International (“LB&I”) division, produced dollar examination results in Fiscal Year (FY) 2005 that were double those in FY 2004 and earlier.² Examination results remained at a higher level in FY 2006 through FY 2011.³

FIGURE 1. LB&I Audit Results, FY2001–FY2011



This paper analyzes the reasons for the increase in examination results in FY 2005 and later through research and analysis of various IRS databases, review of related financial information from SEC filings, and interviews with selected examination teams.

¹ The authors wish to acknowledge comments and assistance from Charles Boynton, and Thomas Brandt. Any errors are solely the responsibility of the authors. The opinions expressed are those of the authors and do not necessarily represent positions of the U.S. Department of the Treasury or the Internal Revenue Service.

² This paper analyzes the magnitude of the additional tax and penalties recommended by auditors at the conclusion of the audits. Some of this “recommended” adjustment is often arbitrated in administrative appeal and/or litigation, resulting in a smaller amount being formally assessed. And, although it is normally not a problem among corporations, the amount that is formally assessed as legally due may not be paid in full. Nonetheless, this paper does not address the assessed or collected amounts that correspond to these recommended amounts—largely because there are often long lags of time between the recommendation and the eventual assessments and collections.

³ For simplicity, this paper will use the current name of Large Business and International (LB&I) for discussing any year within the Fiscal Year (FY) 2001–2011 period. The U.S. federal government uses a fiscal year of October through September. Fiscal Year 2001 is the fiscal year ending September 30, 2001.

The results of this study will provide insights into factors that may have contributed to increased exam results and can be used by LB&I in understanding prior results and for consideration in future decision making.

Examination Closures

When the IRS discusses examination results for a particular year, they mean any examination that closed during that fiscal year. For example, the results for any examination completed in FY 2005 would be included in that year's results. It does not matter as to the tax year of the return involved. The results for a fiscal year include the audit of any return of any tax year that closed in that fiscal year.

IRS Databases

The authors used the Audit Information Management System ("AIMS") and Audit Computer Information System ("ACIS") to analyze examination results from FY 2001 through FY 2011. The Issue Management System ("IMS") was used to analyze specific issues raised by examination field Revenue Agents from FY 2007 through FY 2011. Prior to that, the Coordinated Examination Management Information System for Large Cases ("CEMIS") was used to analyze specific issues from FY 2001 through FY 2006. The CEMIS database is more restrictive in the type of information that can be accessed. CEMIS captured only the top ten issues raised on an examination whereas IMS captures all of the issues raised during an examination. The results are further broken down by LB&I sub-industry (taxpayers with similar principal business activities and a common Standard Industrial Classification (SIC) code) to analyze their contribution to the overall increase in examination results and to determine strategic issues that need the attention of top management to foster voluntary compliance.

Issues to address

1. Why did LB&I field examination results (in dollars) double in 2005 compared with prior years? And why did they remain constant thereafter?
2. Was there a particular sub-industry or Internal Revenue Code Section issue that drove the increase?
3. Were the recommended dollars generated from a small group of entities?
4. What actions should LB&I management take as result of this study to foster increased voluntary compliance?

Findings

1. The FY 2004 LB&I Special Initiative to Improve Business Results by decreasing cycle time on both Industry Cases ("IC") and Coordinated Industry Cases ("CIC") Examinations appears to have been successful.⁴
2. LB&I introduced issue tiering in FY 2006, which did help in focusing IRS resources on the most significant issues.
3. The exam recommended dollars in FY 2005 and thereafter were mostly driven by a small number of sub-industries. These sub-industries are Utilities, High Technology, Petroleum, Commercial Banking, Securities and Financial Services and Telecommunications.
4. The major issues that drove the increase in examination dollars appear to be transfer pricing and capitalization.
5. The increase in recommended dollars appeared to be concentrated in a small group of CIC cases. We identified 147 CIC examinations that drove examination results from FY 2001 through FY 2011.

⁴ LB&I cases fall into two categories, Coordinated Industry Cases (CIC) or Industry Cases (IC). A CIC is a taxpayer and its effectively controlled entities that warrant the application of team examination procedures and meet the required point criteria. A case qualifies as a CIC if after using the point criteria the case totals 12 or more points as outlined in IRM Exhibit 4.46.2-2. An IC is a taxpayer and its effectively controlled entities that warrant the application of Case examination procedures but do not meet the definition of a CIC.

6. Also considered were the fluctuations of Revenue Agent (non-supervisory, bargaining unit employees) resources during the same time period. The number of revenue agents available to perform examinations fluctuated from a high of 4,440 in 2001 to a low of 3,778 in 2003. There was no correlation between revenue agent resources and the number of case closures.

LB&I Special Initiative To Improve Business Results

LB&I set new currency goals for FY 2004 for both IC and CIC cases. The currency goals centered on the average number of months that IC and CIC examinations take. The new goal was 12.7 months for IC cases and 30 months for CIC cases. The initiative also set a goal that all in-process IC cases be closed by April 30, 2004 and all in-process CIC cases be closed by March 31, 2005. LB&I did meet these targets by FY 2005, which resulted in more focused issue examinations. As a result of the tightened cycle time, examiners focused on the most material issues present in the examination. This freed up examination resources to focus on increasing coverage and to focus on areas of greatest compliance risk.

Figure 2 shows the downward trend in cycle times for both IC and CIC examinations due to both the currency initiative and issue focus. In FY 2004, the cycle time for CIC cases was 29.5 months. This amount decreased significantly by FY 2011 to 18.9 months, or a 27 percent decrease in cycle time. For IC cases, the drop in cycle time from FY 2004 to FY 2011 was also 29 percent.

FIGURE 2. LB&I Audit Cycle Time (From Status 12 to Closure), FY01–FY11⁵

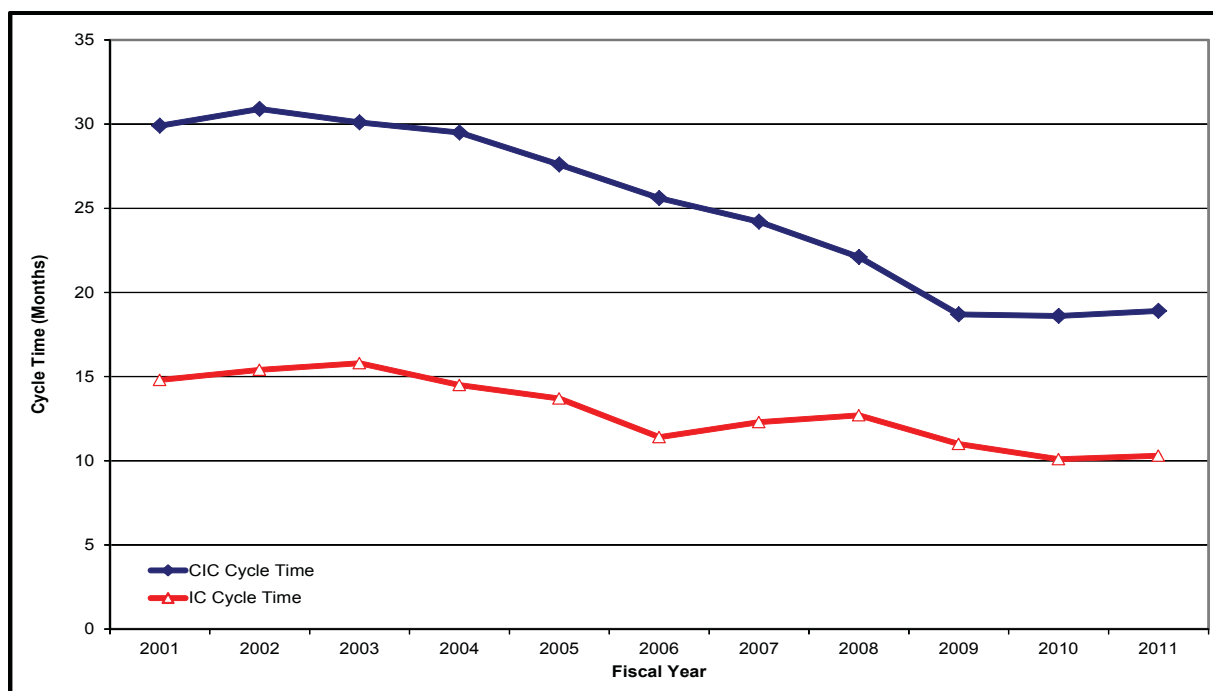


Figure 3 shows that the currency initiative worked for LB&I. Total CIC return closures reached a high in FY 2005 of 5,760. The number of closures dropped off thereafter as a result of LB&I becoming more current in the years under examination. We will later see that the recommended dollars were the highest in FY 2005 and gradually dropped in succeeding years.

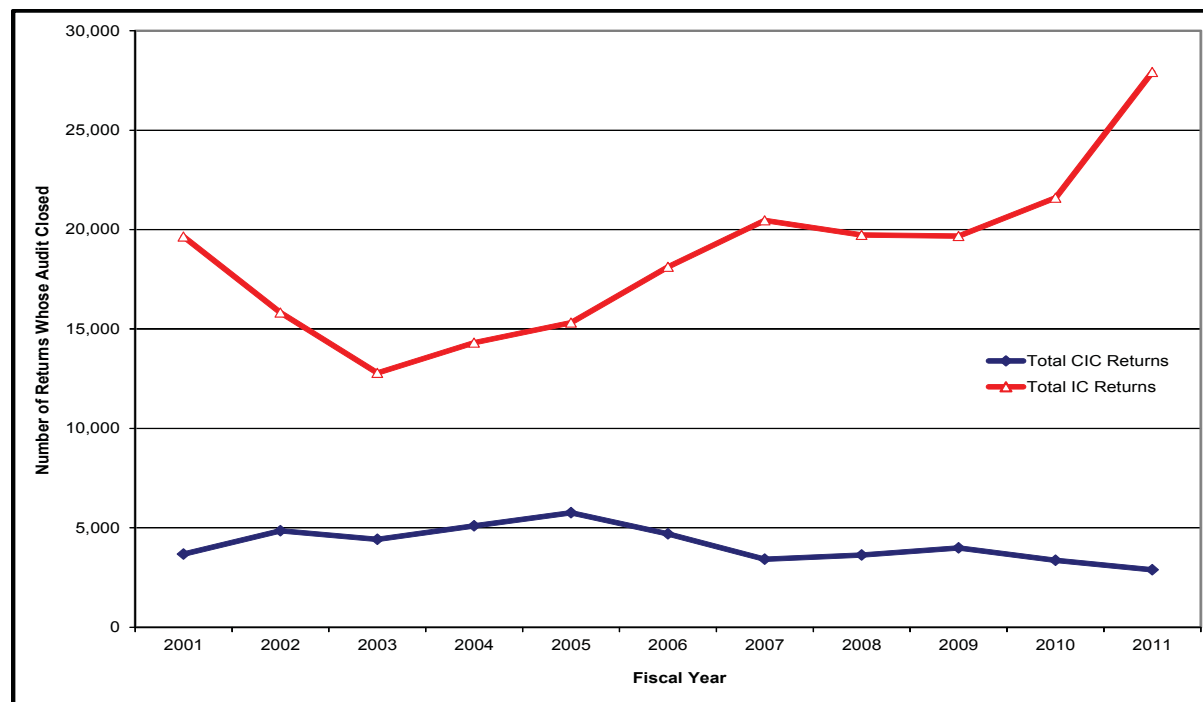
One of the goals LB&I set in FY 2006 was to “improve ability to deploy resources based on risk assessment.”⁶ This goal resulted in more attention to issues with high compliance risk and more examination of IC

⁵ Status 12 indicates that the tax return is in Examination Status.

⁶ Fiscal Year 2006 LMSB Field Focus Guide

cases. The number of IC case closures increased from 15,318 in FY 2005 to 27,926 in FY 2011, or an increase of 82.3 percent. Even though IC cases do not generate as many recommended dollars as CIC cases, the coverage rate was increased for compliance coverage of these taxpayers. Many IC taxpayers, although not as large as the CIC taxpayers, still have very large asset size and operate in a multi-national level.

FIGURE 3. Number of LB&I Return Closures, FY01-FY11



Issue Tiering

In FY 2006, LB&I introduced Issue Tiering as an element of their Issue Management Strategy.⁷ It was designed to prioritize issues in a coordinated manner that provided consistency of treatment among taxpayers. Tier I issues were defined as issues of “high strategic importance” that have a significant impact on one or more industries. Tier I issues included:

- Transfer of Intangibles / Offshore Cost Sharing
- Foreign Tax Credit Generator
- Research Credit Claims
- All Recognized and Listed transactions (Reportable Transactions on Form 8886)
- Section 199, Domestic production Deduction

Data and Analysis

The cumulative dollars recommended by LB&I revenue agents was between \$13.25 billion dollars in FY 2001 and \$15.93 billion dollars in FY 2004. The recommended dollars roughly doubled in FY 2005 to \$31.52 billion and has stayed at a higher level through FY 2011.

⁷ Tiering issues were discontinued on August 27, 2012

TABLE 1. Audit Recommended Dollars for FY 2001 to FY 2011

LB&I Asset Groupings	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11
Total	\$13.25	\$14.30	\$13.04	\$15.93	\$31.52	\$26.68	\$24.87	\$25.20	\$29.65	\$25.23	\$24.78
\$10-\$250M in Assets	\$0.49	\$0.64	\$0.78	\$0.73	\$1.40	\$1.17	\$0.73	\$0.90	\$1.10	\$1.49	\$0.93
Assets over \$250M	\$12.76	\$13.66	\$12.26	\$15.20	\$30.12	\$25.51	\$24.14	\$24.30	\$28.55	\$23.74	\$23.84

Source: ACIS

Table 1 also illustrates that the dollars doubled in FY 2005 among both the largest and the smallest corporations, but the largest dollar increase occurred among the largest taxpayers (assets over \$250 million dollars). The recommended dollars in this group grew from \$15.2 billion in FY 2004 to \$30.12 billion in FY 2005. This group of taxpayers accounted for over 94 percent of the total recommended dollars between FY 2005 through FY 2011. By comparison, the smaller taxpayers do not significantly contribute to the overall dollars recommended by LB&I. The increase in recommended dollars in FY 2005 and FY 2006 may be attributed to the large number of CIC case closures of 3,500 and 2,396 respectively. Many of these cases were closed in FY 2005 and FY 2006 due to the currency initiative. These cases also have been in process for many months (35 months in FY 2005 and 36.8 months in FY 2006), which may indicate that the dollar amount of the issues were large and complex. The number of months the case was in process from Status 12 to closure started dropping off in FY 2007 through FY 2011. The decrease in cycle time is the result of examinations being more current and issue focused.

Table 2 shows dollars recommended from LB&I CIC examinations. Table 2 also illustrates that the increase in examination recommended dollars occurred in the unagreed category. The overall unagreed amount ranged between \$7.16 billion dollars and 9.16 billion dollars between FY 2001 and FY 2004, averaging \$8.33 billion. The average then increased in FY 2005 through FY 2011 to \$17.65 billion, which is a 112 percent increase.

TABLE 2. LB&I Audit Recommended Dollars for CIC by Disposal Code (in \$ Billions)⁸

Fiscal Year	Disposal Code			
	3 Agreed	7 (Unagreed)	Other Disposal Codes	Total
2001	\$0.48	\$9.13	\$0.39	\$9.99
2002	\$1.03	\$9.16	\$0.34	\$10.54
2003	-\$0.19	\$7.88	\$0.62	\$8.31
2004	\$0.36	\$7.16	\$1.66	\$9.19
2005	\$2.17	\$19.69	\$1.00	\$22.85
2006	-\$1.83	\$16.93	\$0.22	\$15.31
2007	\$0.64	\$16.37	\$0.24	\$17.26
2008	-\$0.41	\$14.88	\$0.39	\$14.86
2009	\$2.34	\$20.53	\$0.46	\$23.34
2010	-\$2.35	\$15.79	\$1.05	\$14.49
2011	\$0.45	\$19.36	\$0.63	\$20.44
Total	\$2.69	\$156.89	\$7.01	\$166.59

Figure 4 plots LB&I examination recommended dollars from FY 2001 through FY 2011 in total and by corporation asset size. The large increase in recommended dollars occurred between FY 2004 and FY 2005, from 15.93 billion dollars to 31.52 billion dollars, or a 97.87 percent increase.

⁸ Disposal codes are used to indicate the disposition of an examination. For example disposal code 3 is agreed cases.

Figure 5 plots types of LB&I examination closures. The unagreed dollars (Disposal Code 07) mimics the results for all disposal codes (both agreed and unagreed). Figure 5 illustrates that the majority of examination recommended dollars are unagreed.

Figure 6 tracks only LB&I examination recommended dollars that resulted in an overall additional tax adjustment for the taxpayer. Refund or no-change cases have been eliminated from the data. This graph clearly illustrates that increases in the overall examination recommended dollars mirror unagreed recommended dollars in every year, from FY 2001 through FY 2011. It also shows that unagreed examination recommended dollars are driving total examination results in LB&I.

FIGURE 4. Audit Recommended Dollars by Corporate Assets

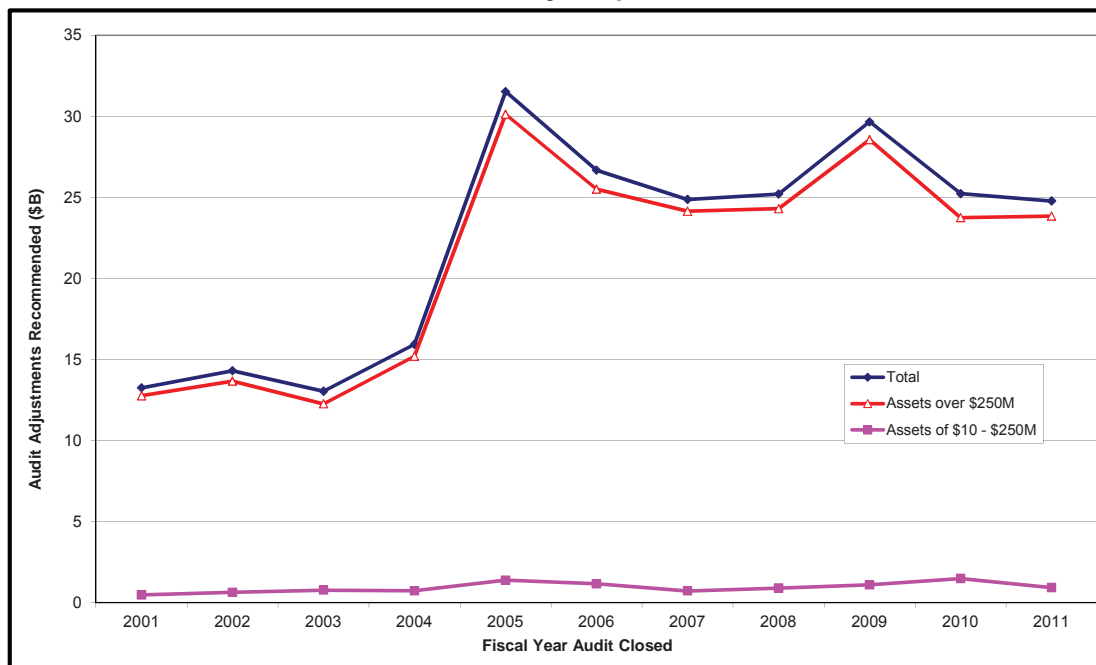


FIGURE 5. CIC Taxpayers All Audit Recommended Dollars by Disposal Code

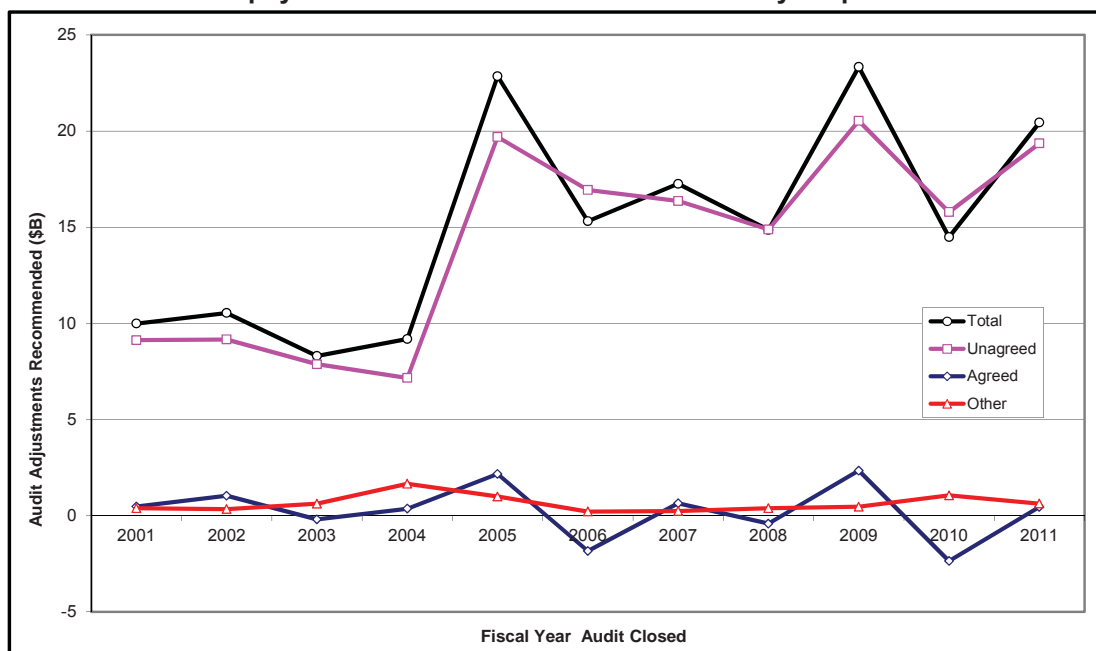


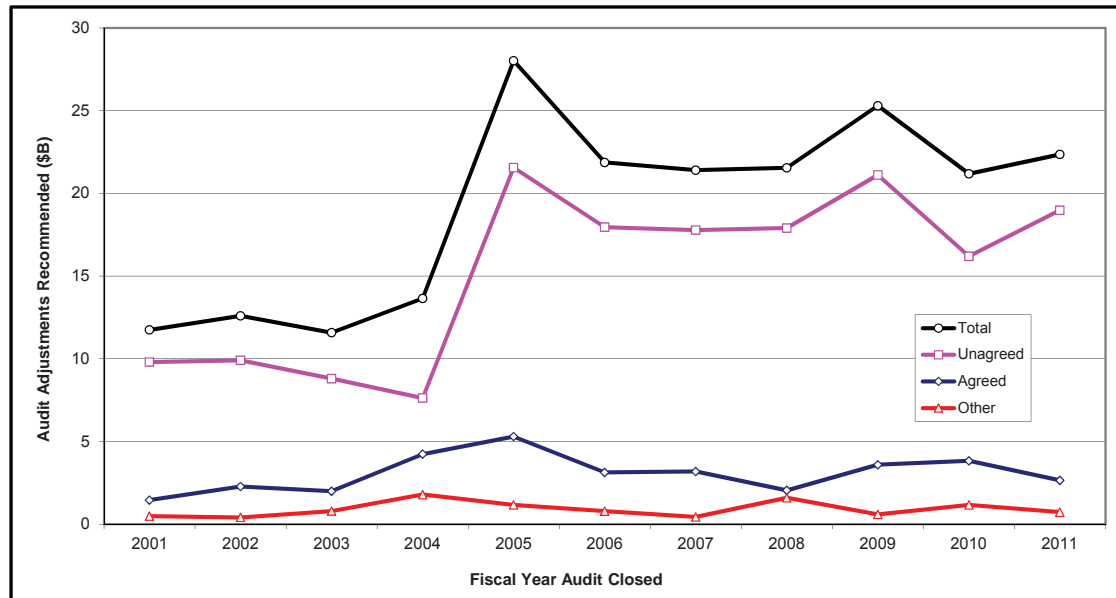
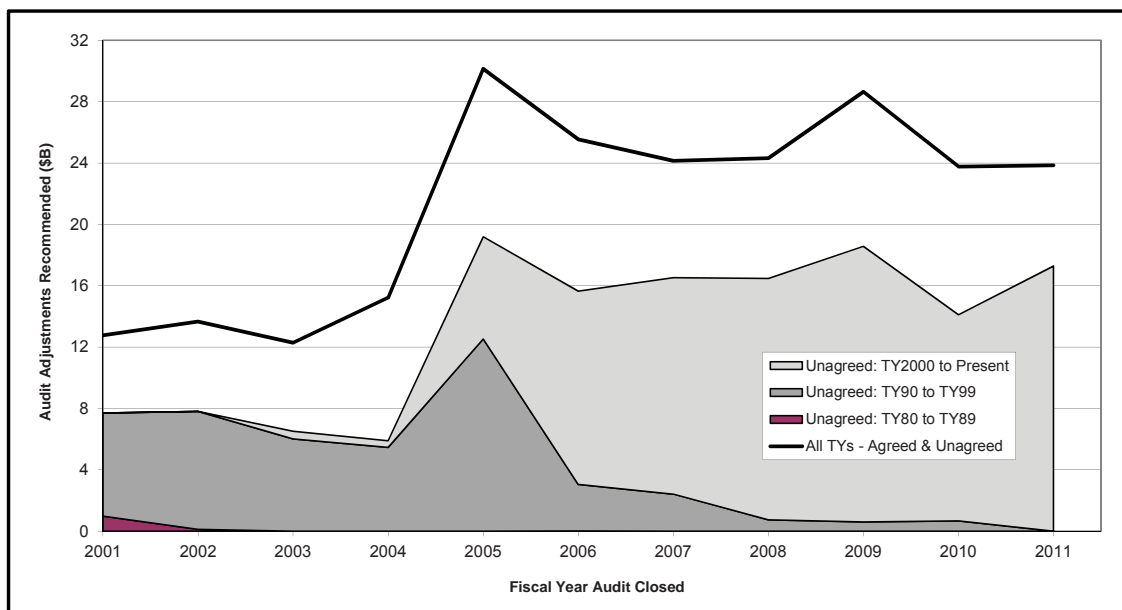
FIGURE 6. Audit Recommended Positive Dollars by Disposal Code, CIC Taxpayers

Figure 7 illustrates the mix of tax years among unagreed cases having aggregated adjustments of at least \$100 million during the period, and compares that with all recommended adjustments. For example, the majority of unagreed recommendations closing in FY 2005 were from the Tax Years 1990 through 1999. Note also that the majority of total adjustments in each year are associated with unagreed cases in which the aggregated recommended adjustment is at least \$100 million.

FIGURE 7. Allocation of Unagreed Recommended Adjustments of \$100M or More Among LB&I Audits By Return Tax Year and Fiscal Year of Closure, Compared with All LB&I Audit Adjustments

Sample Selection

We have previously shown that the majority of examination dollars recommended pertain to CIC unagreed adjustments. We have selected 147 taxpayers with the largest unagreed dollars recommended (unagreed audit amounts exceeding 250 million in total during 2001 to 2011 grouped by Taxpayer Identification Number). See Table 3. The 147 taxpayers accounted for 71 percent of the total dollars recommended, but only 2 percent of the number of taxpayers examined.

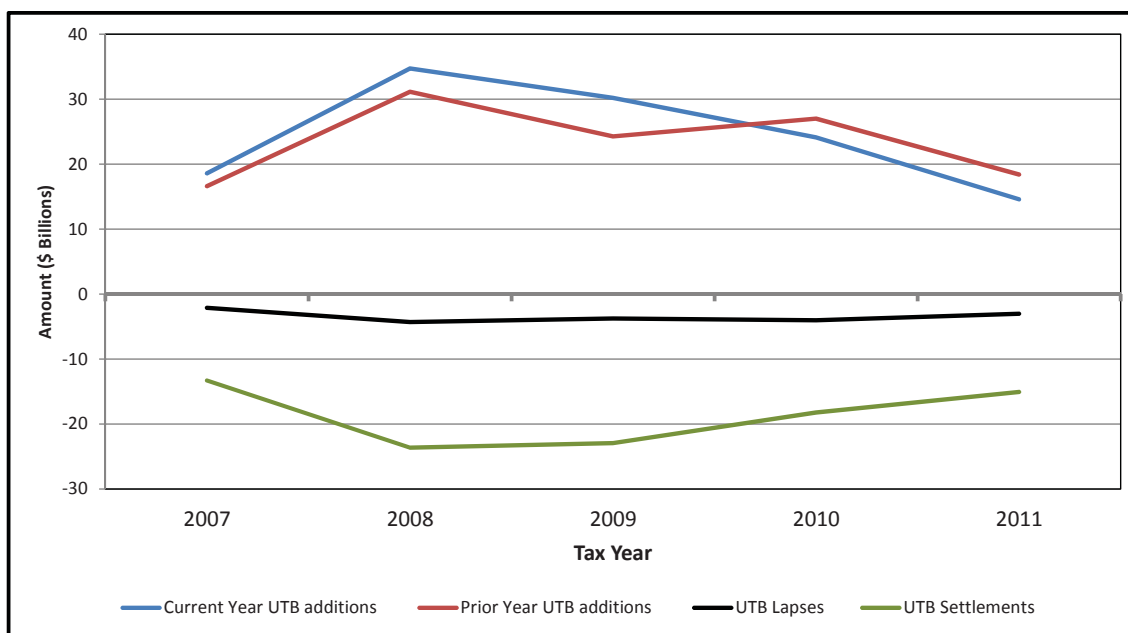
TABLE 3. Comparison of Selected CIC Taxpayers With Total LB&I Population, FY2001-FY2011 Closures

Attributes	Selected CIC Returns	Total LB&I Population	Selected Returns as a Share of the Total
Number of Audited Taxpayers	147	8,443	2%
Number of Audited Tax Returns	6,778	41,873	16%
Recommended Audit Adjustment (\$ Millions)	\$127,203	\$179,886	71%

IRS Audits and Uncertain Tax Benefit (UTB) Financial Reporting

We analyzed public CIC taxpayer financial statements for evidence of the impact of IRS audit exam results on the financial statement reporting of examined taxpayers. Figure 8 reflects financial statement disclosures of 500 of the largest CIC taxpayers' Uncertain Tax Benefit (UTB) movements from TY 2007 through TY 2011.

FIGURE 8. UTB Movement by Tax Year, 500 Largest CIC Taxpayers



In Figure 8, the Current Year UTB addition and Prior Year UTB addition reflect a similar pattern over the 5-year period. Both current year and prior year UTB balances spiked in TY 2008. Recall that Figure 3 shows spikes in FY 2005 and FY2009. During an examination, the notices of proposed adjustment (NOPA) usually are issued throughout the audit for smaller and more agreeable issues. Those proposed audit adjustments for the largest, more complex and contentious issues are routinely issued toward the end of the audit cycle. This is mainly due to the time it takes to collect and analyze all the facts relevant to the issues. The final proposed tax increase probably won't be settled until the end of the audit cycle.

For the exam case closures in FY 2009 in Figure 3, it is reasonable to assume that the audit adjustments were issued and known to taxpayers before FY2009, such as in FY 2008. The spike of the FY 2009 exam result matched a similar spike in financial statement UTB disclosure in TY 2008. That is, the taxpayers knew of the proposed adjustments prior to filing their 2008 financial statements and appropriately increased their income tax reserve taking into account their current information on the status of the LB&I examination.

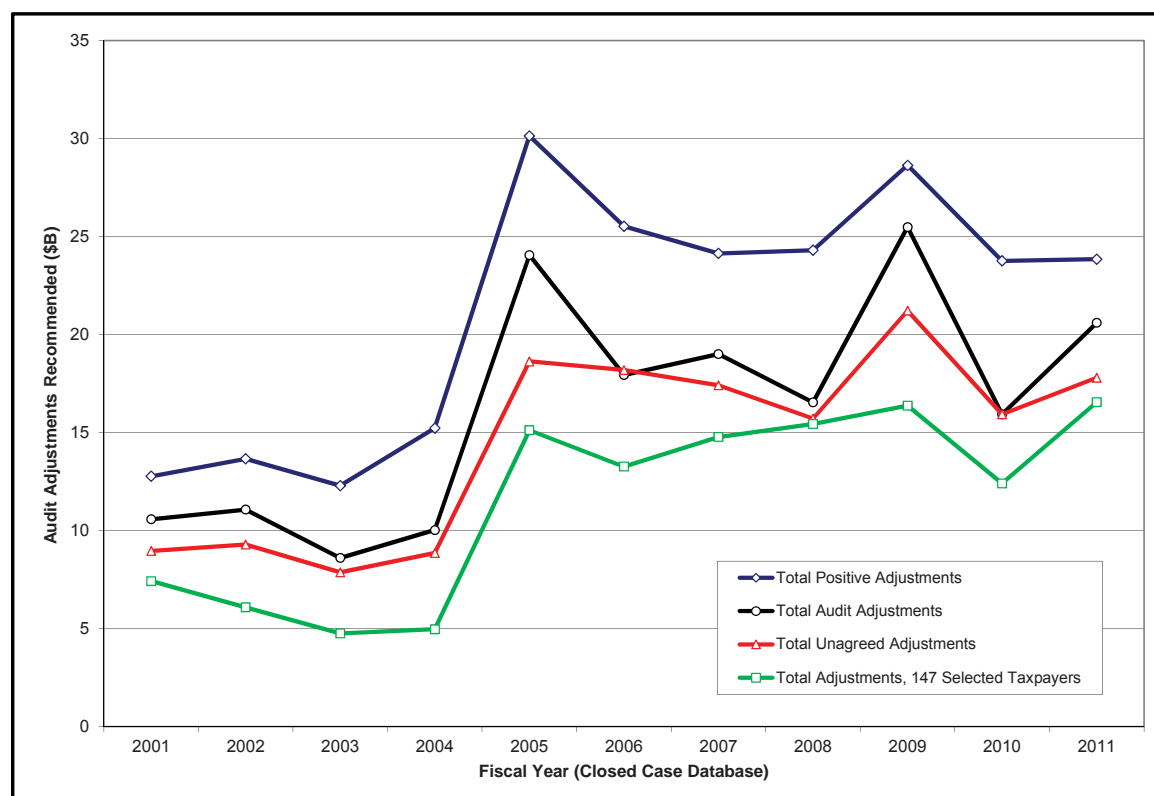
Also interesting is a similar upward movement of the current year UTB and prior year UTB in TY 2008 with a similar downward trend in the years thereafter. There were some internal case studies that demonstrated that taxpayers make a financial statement income tax reserve based on proposed audit adjustments. This explains the correlation of prior year, anticipatory, UTB movements with LB&I exam audit results. The internal case studies, although limited at this point, do support the data pattern between exam audit results and the financial statement reserve movement.

The Schedule UTP filing data for TY 2010 and TY 2011 reflects that the most reported IRC section is Section 41 (Research Credit) and Section 482 (Transfer Pricing), these IRC sections have a recurring effect on the taxpayer's tax return reporting for years to come. This may explain in part why the current year UTB addition has a similar moving pattern as the prior year UTB addition.

Selected Taxpayer Characteristics

Figure 9 breaks down LB&I examination recommended dollars by fiscal year by total positive adjustments (ACIS Table 37), total adjustments, total unagreed adjustments, and the total adjustments for the 147 selected taxpayers.⁹

FIGURE 9. Audit Adjustments of Selected CIC Taxpayers Compared With All of LB&I



⁹ ACIS table 37 refers to unagreed audit recommended dollars without negative adjustment.

The overall LB&I recommended dollars are heavily influenced by the examination outcome of the 147 taxpayers in our study. As the recommended dollars for the 147 taxpayers fell between FY 2001 – FY 2004, the overall examination results also fell. When the recommended dollars for the 147 taxpayers increased in FY 2005, so did the overall results.

Selected Taxpayers—Top Issues Raised by Examination

Figure 10 shows that the average recommended examination dollars for our selected population of 147 taxpayers increased from \$6 billion dollars per year from 2001–2004 to \$15 billion dollars per year in 2005–2011.

FIGURE 10. Average Examination Recommended Amount (in \$ Billions), Selected CIC Taxpayers for Two Periods

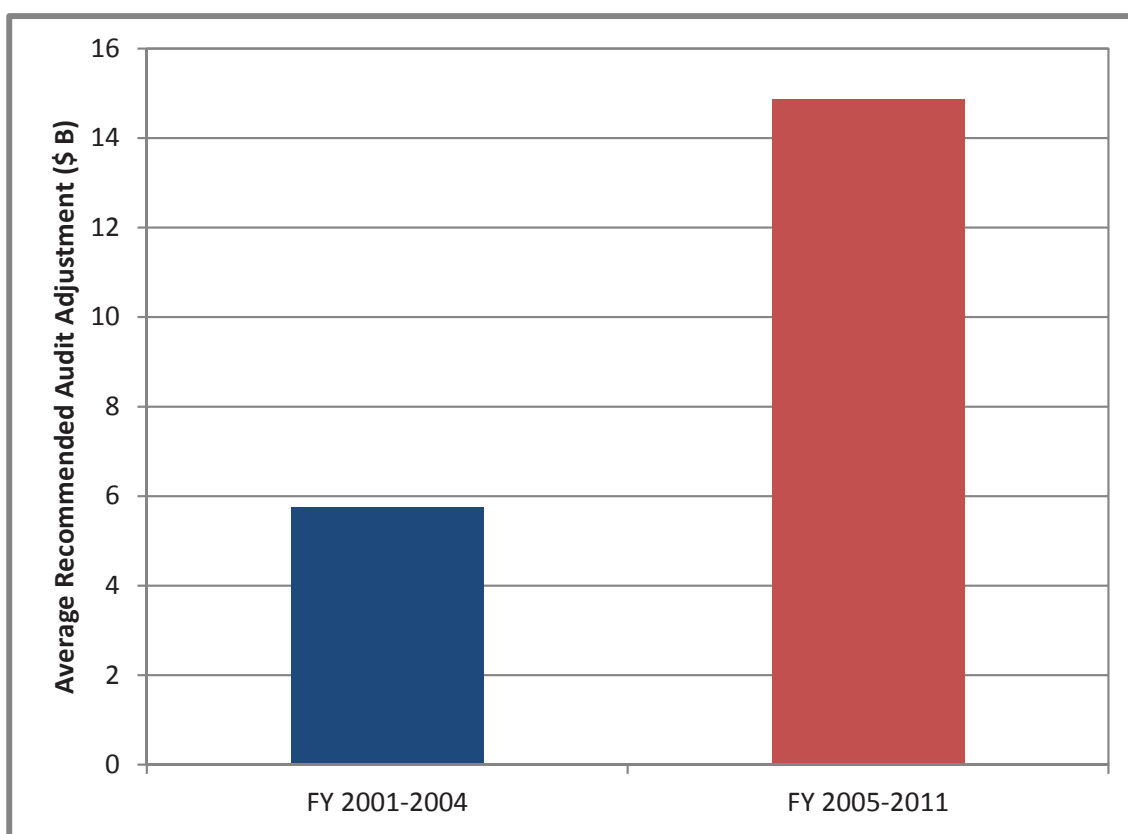


Figure 11 shows average examination recommended dollars by the top six sub-industries from FY 2001–FY 2004 and FY 2005–FY 2011. In all six sub-industries, examination recommended dollars significantly increased.

Figure 12 shows the top ten issues raised by examination (identified by Internal Revenue Code Section and measured by recommended amount) from FY 2007 through FY 2011 for the sample population. Two of the four issues with the most recommended dollars are Credit for Increasing Research Activities and transfer pricing. The Research credit issue continues to generate a lot of audit activity with unagreed recommended dollars of \$19 billion and agreed dollars of \$63 billion.

Figure 12 also reflects that the field responded positively to the tiering issue concept. Transfer pricing and research credit were both designated as Tier 1 issues. The graph above reflects material adjustments in transfer pricing and research credit issues.

Figure 13 shows how the different sub-industries contributed to the selected examination group's recommended dollars by year.

FIGURE 11. Average Audit Recommended Amount (in \$ Billions), Top 6 Sub Industries of Selected CIC Taxpayers for Two Periods

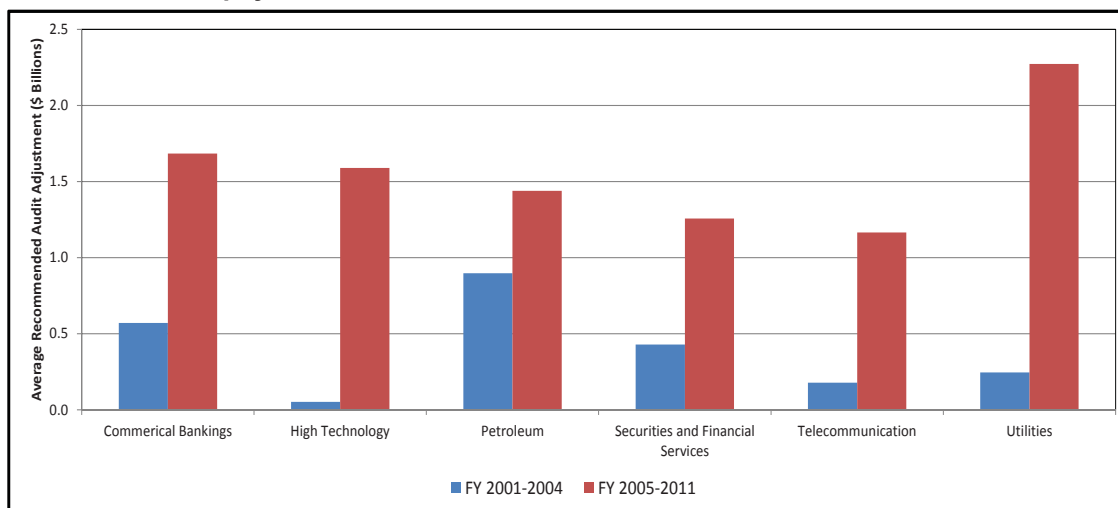
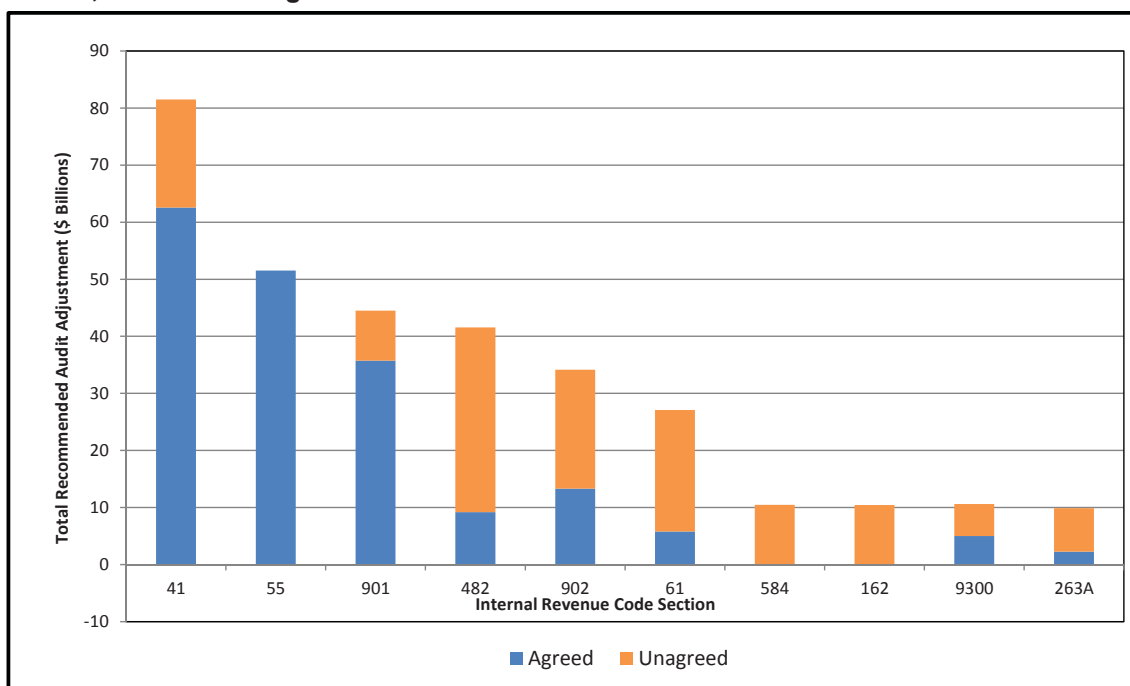


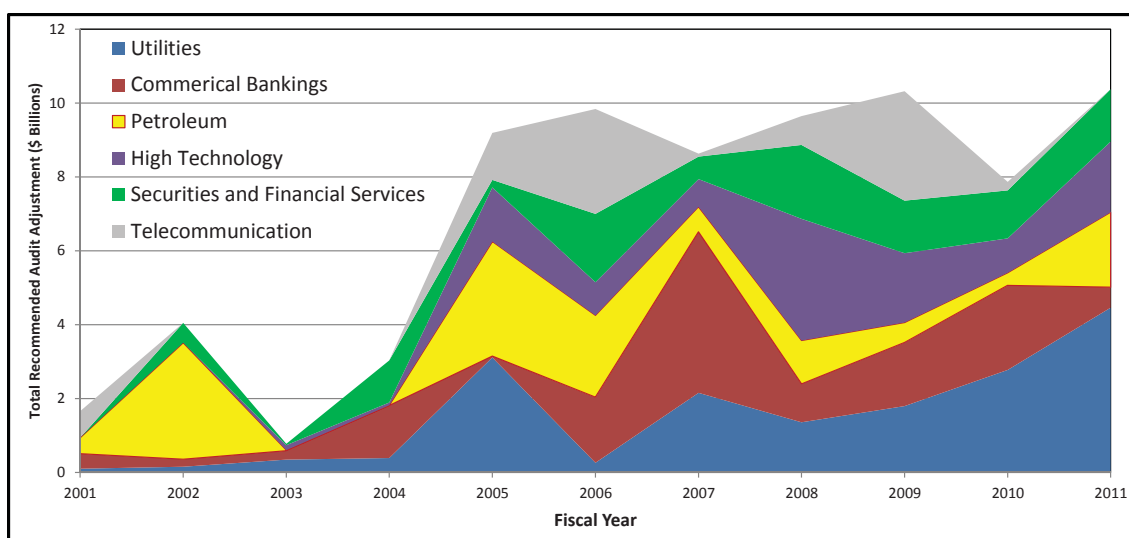
FIGURE 12. Total Amount Recommended (in \$ Billions) Associated With the Eight IRC Sections Having the Largest Amounts, Selected CIC Taxpayers by Agreed vs. Unagreed Issues, FY 2007 through FY 2011



Note: see Table 4 for a description of these Code sections.

TABLE 4. Internal Revenue Code Section Descriptions

IRC Section	Brief Description
41	Credit for Increasing Research Activities
55	Alternative Minimum Tax Foreign Tax Credit
61	Gross Income Defined
162	Trade or Business Expense
263A	Capitalization
482	Transfer Pricing
584	Net Operating Loss Deduction
901	Foreign Tax Credit - Direct
902	Foreign Tax Credit - Deemed paid credit
9300	Sale In / Lease Out (SILO)

FIGURE 13. Total Recommended Audit Adjustment (in \$ Billions) of the Top 6 Sub-Industries Among Selected CIC Taxpayers, FY2001-FY2011

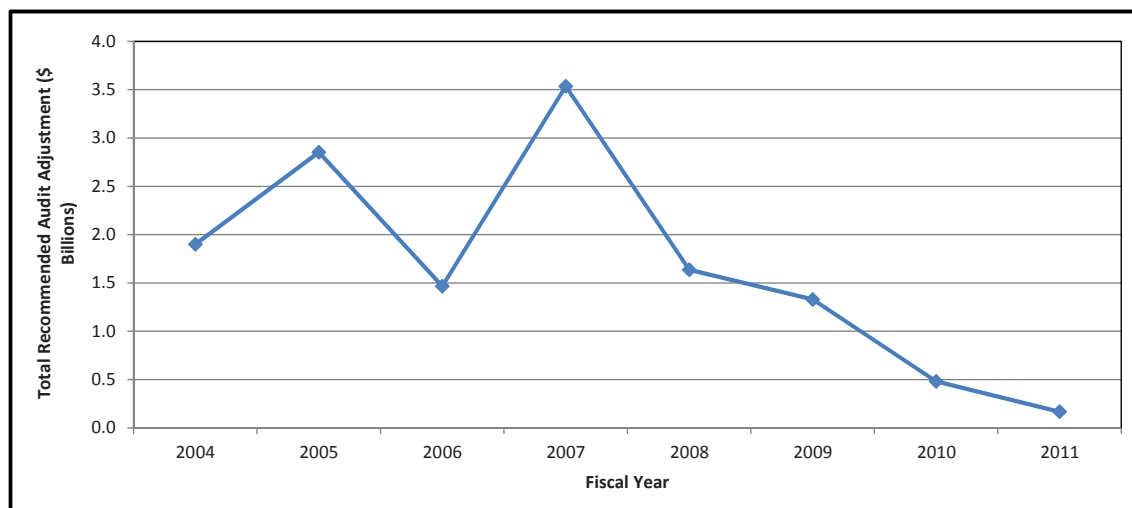
In FY 2002, the Petroleum industry contributed the most to examination recommended dollars, whereas in FY 2007, the Commercial Banking industry contributed the most recommended dollars.

A major LB&I initiative in the early 2000's was corporate tax shelters. Tax shelter cases took longer to close due to the complexity of the issue and the amount of documents involved coupled with extensive depositions. This is the reason why tax shelters were excluded from the currency initiative of 2004. As shown in Figure 14, related tax shelter recommended dollars contributed to the overall examination results in all of the years under study, but especially in FY 2005 and FY 2007.¹⁰ LB&I pushed the examination of listed transactions and initiated promoter examinations in 2001. In a report to Congress, dated 11/20/2003, it was stated that, "The audits began in LMSB in 2001, with 22 entities under investigation. As is apparent, we have increased the number of audits significantly. This includes large accounting firms and major law firms, as well as banks and a number of boutique and mid-size promoters."¹¹

¹⁰ These cases have an identified listed tax shelter. Not all of the recommended dollars necessarily are generated from the shelter activity.

¹¹ Remarks given by IRS Commissioner to the United States Senate, hearing on Abusive Tax Shelters.

FIGURE 14. Total Recommended Audit Adjustment (in \$ Billions) for Cases Closed with a Tax Shelter Project Code, by Fiscal Year of Case Closure



Conclusion

We find that the increase in LB&I examination results is attributable to the following five factors:

1. **The currency initiative:** As part of the LB&I currency and cycle time improvement initiative, the field closed more cases in FY 2004 (deadline for IC cases) and 2005 (deadline for CIC cases). The “old” CIC tax years were closed out as a result of this initiative during FY 2005, which resulted in an increase in examination recommended dollars.
2. **Tax shelter activity:** LB&I investigation of tax shelter promoters started in FY 2001 along with increased corporate tax shelter examinations. As stated above, the cycle time on these cases were longer than non-shelter cases. Shelter cases tended to close out of examination as unagreed cases. The results of these examinations did not start hitting the statistics until FY 2004, with peak years in FY 2005 and FY 2007.
3. **Issue tiering:** LB&I focus on specific issues stated in FY 2006 (issue tiering). Examination teams were mandated to work Tier 1 issues, which included transfer pricing and research credit issues. The result of this mandate generated many of notice of proposed adjustments for tax years FY 2007 through FY 2011.
4. **Sub-industry examination results:** An analysis of the examination results by sub-industry shows that the top six sub-industries increased their proposed dollars recommended from FY 2001–FY 2004 to FY 2005–FY 2011. The sub-industries with the biggest average increase were utilities and high-tech.
5. **The importance of 147 selected cases:** The data for the top six sub-industries include only a portion of the selected population of 147 taxpayers. The 147 taxpayers not in the top six industries were not included. The recommended dollars by sub-industry spiked in different time periods. The High Technology sub-industry (which incurred most of the transfer-pricing issue) and Telecommunications sub-industry generated most of the audit recommended dollars in the FY 2006–FY 2011 period; whereas the Petroleum sub-industry generated most of the audit recommended dollars in the FY 2001–FY 2005 period. The Utilities sub-industry peaked in FY 2005 and FY 2011.